

Intermediaries Supervision Department
The Securities and Futures Commission
8/F Chater House
8 Connaught Road Central
Hong Kong

3 November 2004

Our Ref: JT/L112/04

Dear Sir/Madam:

Consultation Paper on Proposed Measures to Address Risks Arising from Securities Margin Financing

We refer to the captioned consultation paper. While we do not have comment or response to all questions listed in the consultation, we set forth our comments to some of the questions listed as follows.

Q. 2

In general, we support the eventual abolishment of "pooling" of collateral of margin clients who have borrowed and those who have not borrowed in re-pledging. We understand that setting a re-pledging limit on a per firm basis does not address the pooling issue. However, given that we do not yet have an infrastructure to abolish pooling, we agree that setting a re-pledging limit is a step in the right direction. The establishment of a re-pledging limit may force the SMF provider to re-pledge collateral of highest quality to the bank in order to obtain a higher amount of bank borrowing. This would not deter the SFM provider in taking on higher credit risk on lending against low quality stocks. This is particularly true if the re-pledging limit is set on the high end. The higher the re-pledging limit, the lower the investor's protection. Thus, we support the lower limit of 130%.

On sections 5.12 and 5.13, regarding withdrawal of collateral that exceeds the re-pledging limit from banks, there are 2 circumstances under which an SMF provider will have to withdraw excess collateral. (1) when SMF provider reduces the margin loan and (2) when market value of the collateral goes up causing it to exceed the re-pledging limit. Normally, under both sets of circumstances, banks will not have a problem with SMF provider withdrawing excess collateral.

However, the procedure as described in sections 5.12 and 5.13 may not work in a volatile market whereby the aggregate market value of collateral that it has re-pledged with the bank at the end of Day One exceeds the "Re-pledging Limit in Value". The SMF provider is required to withdraw the excess collateral from the bank by the end of Day Two. If the market takes a huge plunge on Day Two, the bank will call for margin against the SMF provider on Day Two and will not allow the SMF provider to withdraw what is now "vanished" excess collateral on Day Two. In such a case, the SMF provider will systematically breach the law.

We also would like to point out the shortcoming of a repledging limit in a rising market. It should be noted that the higher the market value of the collateral, the higher the investor can leverage his position. The systemic risk on the SMF provider is raised when the investor can purchase more when the market goes up and the SMF provider has to fund the difference between the additional lending and the additional bank borrowing confined by the repledging limit. In case the SMF provider is short of funding from other sources, he may be forced to breach the repledging limit by putting up collateral of more than 130% of the margin loan to the bank for funding. This may force the SMF provider to breach the repledging limit.

Q. 3

At a lower re-pledging limit of 130%, we see no reason to introduce a buffer as it defeats the purpose of creating a "re-pledging limit" at whichever level it is set.

Q. 5

We are not in favor of the PBB Model as it is not a practical tool and does indeed place a heavy compliance burden as cited in section 5.24 which outweighs its intended benefit and purpose.

Q. 6-8

We agree that the FRR haircut percentage should be adjusted to improve the risk management mechanism. We support the proposal to increase the FRR haircut percentage rates on listed warrants and illiquid collateral to 100%.

Q. 10

We propose that the transitional period for implementation of the re-pledging limit and revised FRR haircut percentage rates be between 6-9 months. A one-off conversion approach should be adopted as the SMF provider would have restructured its lending portfolio during the transitional period.

Q. 11

Similarly, we propose that the revised haircut rate for listed warrants and illiquid collateral become effective as soon as the FRR amendments come into force.

Q. 12-13

On the Supplementary Measures, we are opposed to section 9.2(a) and 9.6(a). With regards to 9.2(a), we do not understand how the lending amount can be determined against illiquid collateral as the collateral pledged by a client may consist of a number of different shares and both liquid and illiquid stocks. It may be more meaningful to have a notification requirement if the re-pledging limit has been breached a number of times over a month such that the SFC can be made aware of any SMF provider who is tight in its baseline. With regards to 9.6(a), the additional disclosure on monthly statements will add administrative cost without achieving the intended purpose.

Q. 14

We suggest that the implementation period for the Supplementary Measure to be within 6-9 months and be taken in one stage.

Q. 15

We agree that the Commission should consider abolishing the current 5 day grace period for cash client receivables altogether as many unscrupulous brokers are taking advantage of deferred settlement and abusing the current FRR's approach. If a grace period must be granted, we propose that it should not be more than 1 day. Adjustment to the broker's liquid asset should start on S+1 and the outstanding time for the full exclusion of these receivables should be cut down from 1 month to 2 weeks. We do not think there should be any transitional period for this measure.

Q. 18


The CDF and concentrated margin client adjustment should be abolished as the concentrated risk on individual clients is a straight forward function between the margin loan against the value, quality and liquidity of its collateral. Concentration risk for an SMF provider does not arise when lending to client (or group of clients) exceeds a certain percentage of its aggregate margin loan.

Q. 19-20

As stated in the beginning of our submission, we believe that Hong Kong should move towards prohibition of pooling. Under a no-pooling scenario when there is a total segregation of assets between borrowing margin clients and non-borrowing margin clients, there should not be any cap on re-pledging limit on a per client-basis. For example, when a client borrows HKD 1 million from the SMF provider, the SMF provider can re-pledge as much collateral of that client to the bank to obtain HKD 1 million bank loan to fund the margin loan to the client. This practice is fair to the client. In reality, the SMF provider will probably not need to do so as it will have enough capital to fund part of its margin loan.

We suggest that the SFC should work towards (1) capital tiering of SMF providers and brokers of different risk profile according to its size of capital so that different level of regulatory requirements can be mandated for different tiers of brokers and (2) total segregation of client assets between borrowing margin clients and non-borrowing margin clients. To do so, support from the banks and enhancement of the infrastructure such as CCASS are required to abolish pooling.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Jennifer S Teng', written over a horizontal line.

Jennifer S Teng
Legal Adviser/Compliance Officer